S&P Global
Ratings

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Summary:

Distribuidora Internacional de Alimentacion S.A.

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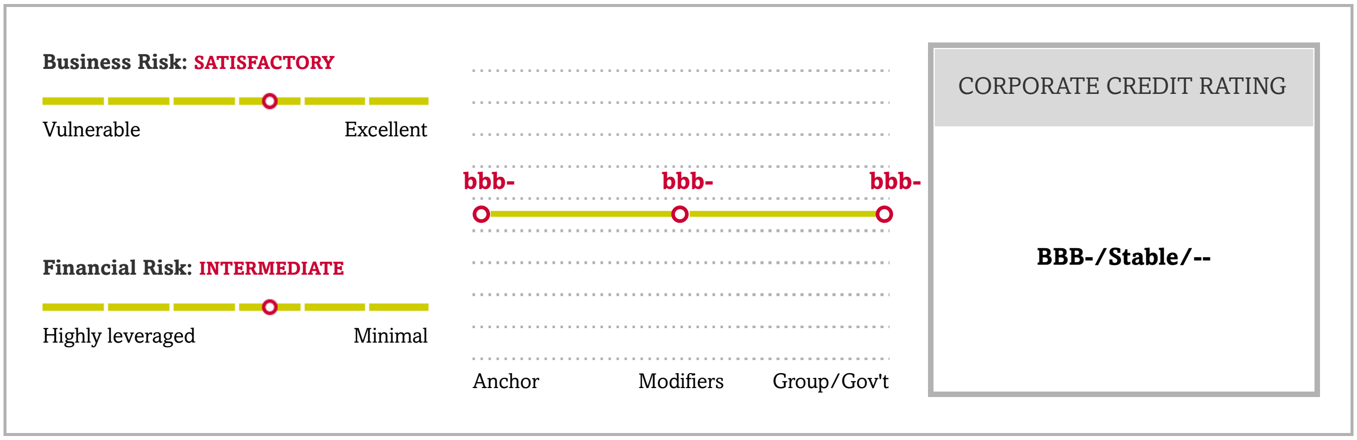

Rationale

Business Risk: Satisfactory	Financial Risk: Intermediate
• Solid market position as the leading hard-discount food retail store operator in Spain, with increasing presence in Latin America (Argentina and Brazil) and China. • Significant market presence of proximity stores in urban areas and rural areas where competition is more limited, as well as also offering multi-formats. • High proportion of private-label penetration and franchisee operated stores (about 60% of stores). • Resilient margin trend through purchasing agreement synergies and tight cost control, but also driven by franchisee model. • Increased competition in the markets where it operates, weighing on prices, as well as exposure to headwinds facing the Brazilian and Argentinian economies.	• Financial flexibility thanks to long-term operating leases with short-notice exit options. • Comfortable debt maturity and strong liquidity. • Financial policy commitment to investment-grade credit rating. • Weak cash flow generation and mostly driven by exceptional working capital movements.

Outlook: Stable

The stable outlook on Spain-based Distribuidora Internacional de Alimentación S.A. (DIA) factors in S&P Global's assumptions that moderately positive operating trends, combined with a prudent financial policy, will enable DIA to maintain credit ratios in line with its expectations for a 'BBB-' rating, namely an adjusted debt-to-EBITDA ratio will below 3x and an adjusted funds from operations (FFO)-to-debt ratio of more than 30%. In our base-case scenario, we assume that like-for-like sales will remain in the positive territory in the Iberian Peninsula ("Iberia"), despite ongoing pricing and competitive pressures.

Downside scenario

We could lower the rating if DIA pursued a more aggressive financial policy that weakens its credit metrics, especially if accompanied by increased acquisition activity and shareholder-favoring initiatives that raise adjusted debt to EBITDA close to 3x, while also posting negative free operating cash flow (FOCF). We could also take a negative rating action if heightened competition, integration challenges from acquisitions, and tougher–than–anticipated macroeconomic trends in Iberia and emerging markets caused operating performance to weaken or profitability to deteriorate substantially.

Upside scenario

We could consider a positive rating action if DIA's sales and profitability increase materially more than we currently anticipate, and if as a result of this, we can reasonably expect a material improvement in the group's discretionary cash flow on a sustainable basis. This would have to be supported by our adjusted debt-to-EBITDA ratio falling below 2x and FFO to debt approaching 45% on a sustainable basis.

Our Base-Case Scenario

Assumptions

- Real GDP growth in Spain of 2.3% in 2017 and 2.0% in 2018, in Brazil of 0.9% in 2017 and 2.0% in 2018, and in Argentina 2.5% in both 2017 and 2018.
- Relatively stable margins, following an improvement of about 50 basis points (bps) in 2016, and despite ongoing price competitiveness in the Iberian and Latin American markets.
- Capital expenditures (capex) of about €325 million in 2017, down from prior years due to lower mergers and acquisitions (M&A) activity.
- Neutral working capital contributions following wide swings in 2015 and 2016.
- No additional shareholder returns other than projected dividends of about €130 million in 2017.
- Full cash credit because cash located in Spain is fully available, as we understand, while cash located in Latin America is faced with local debt DIA can potentially service.

Key Metrics

	2016a	2017e	2018e
EBITDA margin (%)	7.3	7.0–7.5	7.0–7.5
Debt to EBITDA (x)	2.0	1.8–2.3	1.8–2.3
FFO to Debt (%)	40.1	37–42	37–42

All figures are S&P Global Ratings' adjusted.

FFO—Funds from Operations. a--Actual. e--Estimate.

Business Risk: Satisfactory

We assess DIA's business risk profile as satisfactory. This is underpinned by our view of its key position as one of the leading hard-discount food retailers in Spain, with a growing presence in Latin America. We also view favorably DIA's distinct business model, primarily based on a substantial market presence of proximity stores in urban areas. The business model is further enhanced by the significant share of franchise stores (about 60% of DIA's total number of stores are franchised), which lowers net sales and gross margins, but improves the group's overall profitability and allows for a more efficient capital allocation. Further positive factors to the business risk profile assessment include the nondiscretionary nature of food spending, as well as a high private label penetration of more than 50%. However, the business risk profile is constrained by the highly fragmented and competitive markets in which DIA operates and a much smaller and less diversified business than peers, as it generates close to 80% of EBITDA in Iberia.

2016 results showed a good performance with some improvement in the like-for-like trend in Spain, an overall 50bps expansion in S&P Global Ratings' adjusted EBITDA margins, mostly driven by the ramp-up of recent acquisitions, as well as benefits from recent purchasing partnerships with Eroski, Intermarché, and Casino, which we expect to continue to be positive in 2017. Still, 2016 saw a challenging year in Spain with low inflation and volume contraction and tough competition (the Spanish operations reported revenues down 0.2% in 2016). We expect better trends in 2017, with inflation at 1.4% (versus negative 0.4% in 2016) and better volume trends (negative 1.6% in 2016). However, competition is fierce, with Mercadona, Lidl, and Carrefour Express gaining market share, and Mercadona announcing significantly higher investment plans (€400 million higher capex for 2017).

Online sales are also lagging those of peers, representing only about 1% of DIA's total sales in Spain (still loss-making overall) and about 3% in Madrid (slightly profitable). We also note DIA's agreement with Amazon (for its Amazon Prime offering), but we do not see an important benefit so far.

Franchisees are in good shape, as we see it, with improving satisfaction levels and relatively stable churn rates.

In Latin America, we view Brazil and Argentina as benefitting from positive economic tailwinds and we expect DIA's performance there to improve in 2017. We overall expect a relative resilient trend in margins, which are at the higher end when compared with those of other European peer food retailers. Margins in 2017 will also be supported by the recent private label partnership agreement signed with Eroski in March this year.

Overall, for 2017, we see a relatively stable business, despite limited top-line improvement in Iberia, but supported by margin resilience and overall positive trends in Latin America.

Financial Risk: Intermediate

DIA's prudent financial policy should support credit ratios commensurate with our intermediate financial risk profile, including S&P Global Ratings-adjusted debt to EBITDA of about 2.0x and S&P Global Ratings-adjusted FFO to debt above 35% in 2017. We expect shareholder remuneration to be at the high end of 50% of the group's net income (according to management's guidance), with no exceptional dividends or share buybacks. Furthermore, we anticipate limited M&A activity over the next 12-24 months.

We view DIA's operating leases as artificially short, relative to the length of expected use of the leased assets and, hence, make an analytical adjustment to reflect a more economically appropriate depiction of the lease obligation on a going concern basis. Still, we view DIA's operating flexibility as a result of its long-term operating leases with short notice exit options as a positive to the overall financial risk profile. In addition, we positively view DIA's commitment to investment-grade ratings.

2016 saw a very high FOCF relative to slightly reducing sales and it is mainly attributable to working capital movements (€155 million outflow in 2015 vs. €300 million inflow in 2016). Overall FOCF in 2016 was €425 million, where about €300 million is explained by exceptional working capital movements. We do not believe these levels of FOCF are sustainable. We also note that, although leverage decreased by 0.5x, EBITDA interest coverage reduced to 9.5x from 13.6x in 2015, and we understand it is mostly driven by interest payments in Latin America.

Over 2017, we expect DIA to sustain its positive FOCF trend, although at more normalized and lower levels than in 2016, as we expect limited impact coming from working capital movements. We anticipate credit metrics to remain in line with those reported in 2016, including debt to EBITDA around 2.0x and FFO to debt of close to 40%. The unadjusted EBITDAR (EBITDA plus rent) interest plus rent coverage ratio (EBITDAR coverage) should remain very close to 2.5x.

Liquidity: Strong

We consider DIA's liquidity to be strong, supported by:

- Our projection that DIA's sources of liquidity, including cash and projected cash flows, will exceed its uses by 1.5x or more over the next 12-24 months;
- Our forecast that net sources of cash will remain positive even if EBITDA declines by 30% from our base-case operating scenario in the coming year;
- Our projection of sufficient covenant headroom for forecast EBITDA to decline by 30% without the company breaching the tests of the financial covenants included in the documentation for its credit facilities;
- The likely ability to absorb high-impact, low-probability events without refinancing over the next 12-24 months; and
- Our view of the company's generally prudent risk management.

Principal Liquidity Sources	Principal Liquidity Uses
• About €365 million of unrestricted cash and cash equivalents (after taking into consideration full cash credit) as of Dec. 31, 2016; • About €600 million of undrawn credit facilities maturing in 2020 and 2022; and • About €450 million of projected FFO in 2017.	• Estimated €325 million of capex in 2017, representing about 3.5% of net sales; • About €130 million of dividend payments recorded in 2017; and • Intra-year seasonal working capital requirements of about €300 million.

Ratings Score Snapshot

Corporate Credit Rating

BBB-/Stable/--

Business risk: Satisfactory

- **Country risk:** Intermediate
- **Industry risk:** Intermediate
- **Competitive position:** Satisfactory

Financial risk: Intermediate

- **Cash flow/Leverage:** Intermediate

Anchor: bbb-

Modifiers

- **Diversification/Portfolio effect:** Neutral (no impact)
- **Capital structure:** Neutral (no impact)
- **Financial policy:** Neutral (no impact)
- **Liquidity:** Strong (no impact)

- **Management and governance:** Satisfactory (no impact)
- **Comparable rating analysis:** Neutral (no impact)

Related Criteria And Research

Related Criteria

- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Corporate Methodology, Nov. 19, 2013
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Key Credit Factors For The Retail And Restaurants Industry, Nov. 19, 2013
- Group Rating Methodology, Nov. 19, 2013
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Use Of CreditWatch And Outlooks, Sept. 14, 2009
- 2008 Corporate Criteria: Rating Each Issue, April 15, 2008

Business And Financial Risk Matrix

	Financial Risk Profile					
Business Risk Profile	Minimal	Modest	**Intermediate**	Significant	Aggressive	Highly leveraged
Excellent	aaa/aa+	aa	a+/a	a-	bbb	bbb-/bb+
Strong	aa/aa-	a+/a	a-/bbb+	bbb	bb+	bb
Satisfactory	a/a-	bbb+	**bbb/bbb-**	bbb-/bb+	bb	b+
Fair	bbb/bbb-	bbb-	bb+	bb	bb-	b
Weak	bb+	bb+	bb	bb-	b+	b/b-
Vulnerable	bb-	bb-	bb-/b+	b+	b	b-

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